No. 82-868

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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To The Honorable, The Chief Justice And Associate Justices Of The Supreme Court Of The United States:

Record Wide Distributors, Inc., the petitioner herein, prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in the above entitled case on July 14, 1982

QUESTIONS PRESENTED

1. Taxpayer, for the years in question, used a cash method of accounting which was also referred to as a hybrid method of accounting. The revenue agent changed taxpayer from cash to the accrual method of accounting. The question presented is whether the revenue agent can change the taxpayer's method of accounting without first finding that taxpayer's method did not clearly reflect income as required by IRC Section 446 (b);

2. Must a taxpayer using inventories as a part of its accounting method be mandated to use a strict accrual method of accounting even though IRC Section 446 (a); Reg. 1-446-(a) (1) allows the taxpayer to compute its taxable income on the basis of which the taxpayer regularly computes its income?

3. Does a revenue agent who has no proven qualifications in accounting background or expertise possess the broad discretionary power of the "Commissioner" in making decisions relative to what accounting methods do or do not clearly reflect the income of the taxpayer.

4. Should this Court recognize that a deduction for a bad debts reserve in the year 1974 should be allowed to Petitioner who has been changed from cash to the accrual method of accounting by an audit in 1976? Should not the right to use and take advantage of such a bad debt deduction be allowed to Petitioner as is allowed all other accrual basis taxpayers?

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OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Eighth Circuit, and whose judgment is sought to be reviewed, is reported at 682 F2d 204 and is reprinted in the separate Appendix A hereto, pages A-1-A-7. The prior opinion of the Tax Court of the United States is reprinted in Appendix C hereto, pages A-9-A-19 and is reported at TC Memo 1981-12.

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit (Appendix A pages A-1-A-7) was entered on July 14, 1982. A timely petition for rehearing was denied on August 24, 1982. (Appendix B hereto, page A-8). The jurisdiction of the Supreme Court is invoked under 28 USC 1254 (1).

STATUTES AND REGULATIONS INVOLVED

IRC Section 446 and subsection (a) (b) and (c)

IRC Section 166, subsection (c)

Reg. 1-446-1 and subsections (a), (b), and (c)

Reg. 39-41-1 (1939)

Reg. 39-41-2 (1939)

The above Statutes and Regulations are set out in the Reasons for Granting Writ.

STATEMENT OF THE CASE

This is a case for the determination of deficiencies for Petitioner's income taxes for the years 1972, 1973 and 1974. The Tax Court determined those deficiencies in the amounts of $53,947.55, $47,985.17 and $31,203.54 respectively after finding that the Commissioner properly changed Petitioner from the cash to the accrual method of accounting. Petitioner had been placed on the accrual method of accounting after consistently using a cash method for the three years in question. The authority for the Commissioner to do this under his regulatory power has been challenged by the taxpayer for the reason that its method clearly reflected income and was, therefore, not subject to being validly changed by the Commissioner. The Commissioner's evidence contained no reference to the taxpayer's method as not clearly reflecting income. The Commissioner's position is that the use of inventories by the taxpayer mandated the accrual method, therefore, the Commissioner changed taxpayer's method from cash to accrual. The Tax Court upheld the Commissioner, as did the Eighth Circuit Court of Appeals.

There are secondary issues involving the proper or improper accrual of accounts receivable and the disallowance by the Commissioner of a bad debt deduction of a substantial amount.

Petitioner is a Missouri corporation, incorporated on March 7, 1972. Prior to that, the business was operated as a sole proprietorship known as "Bootheel Records." The corporate income tax returns for calendar years 1972, 1973, and 1974 were filed with the IRS Service Center at Kansas City, Missouri. The returns were prepared by Dennis G. Scharf for 1972, and Keith Robley, a C.P.A., for 1973 and 1974. The returns were prepared on the cash method of accounting.

Petitioner's corporate name is Record Wide Distributors, Inc. Petitioner is a wholesaler of phonograph albums, 8-track stereo tapes and cassettes. Among the products that they handle are cut-outs. Cut-outs are merchandise that the manufacturer cannot sell in its market place. Therefore, the manufacturer has to do something to get rid of these products, and they sell off these products (called loads) at some price to the highest bidder, or on a negotiated basis. Petitioner buys these cut-outs which have limited value and then puts a price on them that it thinks the product will bring in its distribution channels. Ninety to ninety-five per cent or more of Petitioner's business is in this cut-out merchandise. When Petitioner buys a "load" from a manufacturer, it receives, perhaps, one good title and four or five bad titles. Petitioner must buy the whole load and cannot pick and choose titles.

Petitioner ships these products (records and tapes) to various retail outlets throughout the country. The titles are selected by Petitioner and sent out to customers with a guarantee that any products not sold by the customer can be returned for full credit. The customer does not have to pay for the records until they sell them. Until all the records are sold (or the unsold records returned) there are no monies coming to Petitioner. As an example, if 50,000 records were shipped, no money would be due Petitioner until they were sold and until the customer returned what was not sold and then the customer would pay the difference. There are no written agreements with customers.

The return privilege is open-ended. It can go on for years. Petitioner acknowledged that this was a risky way to do business, but their business has increased throughout the years.

When Petitioner ships merchandise to the retailers, it also sends invoices to the customers. These are for the convenience of the customer. However, Petitioner has no way of knowing what his true accounts receivable are. The receivables mean nothing. Petitioner cannot depend on any definite amount of money from them at any definite time.

Petitioner's Vice-President estimated that its returns for merchandise shipped each of the years 1972, 1973, and 1974 were between 50 and 60 per cent, perhaps higher, as such returns were applied to purported receivables at the end of those years. Petitioner made this estimate based upon his examination of the 1978 returns in the year 1979. Also, he based his estimate for 1972, 1973, and 1974 on his experience in managing the company in those years.

Mr. Keith Robley, a certified public accountant and accountant for Petitioner, had audited businesses and prepared tax returns since 1956. He prepared the 1973 and 1974 returns of Petitioner and examined the 1972 return. He gave his opinion that the manner in which Petitioner's income was reported accurately portrayed Petitioner's income.

The facts relating to a secondary issue in the case are that one of the large retail customers of Petitioner, Sound On, owed Petitioner in excess of $176,000 at the end of the calendar year 1974. Due to Sound On's precarious financial position in 1974, Petitioner had placed Sound On on a C. O. D. basis for credit purchases for the reason of nonpayment of Sound On's past due balance. Because it filed its returns on a cash basis, there was no reason for Petitioner to use a deduction for bad debts on its 1974 return because Petitioner had never accrued and reported the sales to Sound On as income. Consequently, when

the revenue agent changed taxpayer's accounting method from cash to accrual in 1978 for the year 1974, she did not allow for any bad debt deduction for the debt of Sound On.

Rose Marie Stuckey, and IRS agent, was assigned to audit the 1972 returns of Petitioner. She also audited the 1973 and 1974 returns after potential adjustments to the 1972 returns. On her audit, she changed the method of accounting of Petitioner from cash to the accrual method. She increased the gross sales for each year by the increase in accounts receivable and made an appropriate increase or decrease to gross sales, based upon the increase or decrease in accounts payable. She did this because Petitioner maintained an inventory and derived its gross income from the sale of tapes and records and, therefore, she stated, the regulations required that Petitioner use the accrual method of accounting. The amounts of the increases were stipulated to be $207,775.41 in 1972; $55,759.47 in 1973; and $44,233.93 in 1974. However, she refused and the Tax Court upheld the disallowance of any bad debt deduction for Sound On for the year 1974.

Jurisdiction of the Tax Court arose after the taxpayer received notice of deficiencies for the years 1972, 1973, and 1974 by letter from the Regional Commissioner dated July 11, 1978. Taxpayer then filed its Petition in the Tax Court within ninety (90) days after receipt of such notice. After the decision of the Tax Court was rendered on April 10, 1981, Petitioner filed its motions to vacate or revise its decision and for reconsideration of its findings and opinion. These motions were denied on May 14, 1981 and Notice of Appeal to the Eighth Circuit Court of Appeals was filed on August 10, 1981, within ninety (90) days of the denial of Petitioner's motions. Jurisdiction of the review of the decision of the Tax Court in this case arises under the provisions of Section 7482 (a) of the Internal Revenue Code.

REASONS FOR GRANTING THE WRIT

I

Certiorari Should Be Granted For The Reason That The Eighth Circuit Court Of Appeals Has Decided A Question Of Federal Law Involving The Use Of Inventories Which Has Not Been, But Should Be, Settled By This Court. In Addition, There Appear To Be Conflicts Between The Eighth Circuit And Other Circuits On This Question.

The Court of Appeals held that the use of inventories by the Taxpayer "clearly mandate the use of an accrual accounting method," (Opinion p. 3 App. A-5) and, therefore, the Commissioner did not abuse his discretion by changing the accounting method of the Taxpayer from cash to accrual. Of all the decisions relating to the authority of the Commissioner to change a taxpayer's accounting method, none have been so sweeping as to hold that the use of inventories, alone, mandate an accrual method of accounting for reporting income. We do not believe that, as an abstract statement of law, the use of inventories mandate the taxpayer to use a strict accrual method of accounting. This court has not decided such issue even though the various circuits have skirted the question by relying on various fact situations to arrive at their conclusions. Therefore, we think it imperative that this court declare itself on this important question. The First Circuit has acknowledged that the Tax Court, in a variety of contexts, has recognized that the presence of inventories does not necessarily mean that the cash basis does not clearly reflect income. *Wilknison - Beane, Inc.* v. *CIR,* (C.A. 1) 420 F.2d 352, footnote 9, under which the following cases and authorities were cited: *Ezo Products Co.*, 37 T.C. 385, 393 (1961); *Estate of Howard T. Roe,* 36 T.C. 939, 952 (1961); *Michael Drazen, supra,* at 1079; *Stanford R. Brookshire,* 31 T.C. 1157, 1166 (1959), aff'd, 273 F.2d 638 (4th Cir.), cert. denied, 363 U.S. 827, 80 S.Ct. 1597, 4 L.Ed.2d 1523 (1960); *Theodore H. Beckman,* 8 B.T.A. 830, 831 (1927); *2 J.*

Mertens, Law of Federal Income Taxation Sec. 16.03, at 6 (Malone rev. ed. 1967); *contra Harry Hartley*, 23 T.C. 353, 358 (1954).

This case is centered upon IRC Section 446 and the regulations thereunder. IRC Section 446 reads as follows:

> (a) **General rule.** Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) **Exceptions.** If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.
>
> (c) **Permissible methods.** Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—
>
> > (1) the cash receipts and disbursements method;
> >
> > (2) an accrual method;
> >
> > (3) any other method permitted by this chapter; or
> >
> > (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.
>
> (d) **Taxpayer engaged in more than one business.** A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade of business.
>
> (e) **Requirement respecting change of accounting method.** Except as otherwise expressly provided in this chapter, a

taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate. (Aug. 16, 1954, Ch. 736, Stat. 151.)

Excerpts from pertinent subsectons of Reg. 1-446-1 are as follows:

(a) General rule.

(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items.

* * *

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflect-

ing income, provided all items of gross income and expenses are treated consistently from year to year.

* * *

(b) **Exceptions.** (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(c) **Permissible methods—(1) In general.** Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

* * *

(2) **Special rules.** (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

The three basic subsections of the regulation that we are concerned with are (a), (b) and (c). We shall take them in order and comment on the reported decisions as they affect our fact situation.

(a) General Rule

Petitioner used the cash method of accounting in reporting its income although the tax court termed it a hybrid method. The parties stipulated that such was the method used. This method was used by the sole proprietor predecessor of Petitioner. Subsection (1) recites that Petitioner can use the cash disbursement method or a combination of cash and accrual. Subsection (2) recites that it is recognized that no uniform method can be prescribed for all taxpayers. It also recites that the taxpayer can

adopt such forms and systems as are, in his judgment, best suited to his needs. It also recites that no method is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. With these allowances in mind, Petitioner's evidence showed:

1. Petitioner and its predecessor used the cash method for several years. (TR 88 App. A-25)

2. It was best suited to its needs. (TR 111-112-113 App. A-35-A-37)

3. It clearly (accurately) reflected its income. (TR 88-92 App. A-25-A-29; 101-113 App. A-29-A-37)

Petitioner was entitled to select a method of accounting on the basis of which it regularly computed its income in keeping its books. IRC Sec. 446(a); Regs 1-446-1(a). Petitioner was incorporated on March 7, 1972. It used the cash method of accounting for the calendar (taxable) years 1972, 1973, and 1974. This method selected was not changed by Petitioner for those years. The selection of the accounting system was lodged exclusively in Petitioner as long as it was within the statutory limits. *Huntington Securities Corporation* v. *Busey* (6 Cir. 1940), 112 F.2d 368, 25 AFTR 82 rev'g (DC Ohio), 26 F.Supp. 849, 22 AFTR 802.

The Commissioner's agent and auditor, Rose Marie Stuckey, stated that "The regulations require that whenever a taxpayer uses an inventory to compute their gross profit, they must use the accrual method of accounting." (TR 183-184 App. A-42-A-44)

There was no evidence from the Commissioner that Petitioner's accounting method did not clearly reflect income. The Commissioner (Rose Stuckey, the agent auditing the returns) rested on her finding that Petitioner used inventories in its accounting method and was, therefore, required to use the accrual method.

(b) Exceptions

This is the only provision in the code and regulations in which the Commissioner has the authority to change the accounting method of a taxpayer, and that authority does not arise until the Commissioner has made a finding that the Petitioner's method did not clearly reflect income. In construing tax statutes, the familiar rule prevails that the natural and ordinary meaning of the words used will be applied unless the Congress has definitely indicated an intention they should be otherwise construed. *Huntington, supra,* at 370. The Commissioner's authority to order a change in Petitioner's accounting method, when Petitioner regularly employed consistent methods, depends upon the Commissioner's finding that Petitioner's method did not clearly reflect income. *Glenn* v. *Kentucky Color and Chemical Co., Inc.,* 1949, D.C. Ky. 87 F. Supp. 618, aff'd (CA 6) 186 F.2d 975; *Ezo Products* v. *Commissioner, supra.*

The Commissioner may contend that the statement in the notice of deficiency constitutes such a finding. However, such notice was never admitted into evidence, and even if it were offered, it would not be admitted because agents' reports are hearsay. *Victor and Evelyn Blanco,* 56 T.C. 512; T.C. Memo 1973-247, T.C. Rule 143(b). Even if it was admissible, and such finding was presumed to be correct, the Commissioner must be held to the rule that once a taxpayer introduces competent and credible evidence tending to prove the deficiency was wrong, such presumption of correctness disappears and the presumption of correctness is overcome. *Griffin* v. *Commissioner,* 285 F.2d 91. The presumption of correctness disappears once evidence which would support a contrary finding is introduced. *Neiderkrome* v. *Commissioner,* 266 F.2d 238. The Petitioner's evidence that its accounting method conformed to its own unique method of doing business and the statement by two witnesses (TR 88-92 App. A-25-A-29) that it clearly reflected income would support a contrary finding to that of the Commissioner.

The arbitrary decision of Rose Stuckey to change the accounting method was not based upon any other reason than the fact that Petitioner used inventories. She made no finding that Petitioner's method did not clearly reflect income. She knew the policy on credits (returns) of Petitioner and that they appeared very large. She knew that Petitioner had a liberal return policy and that they had a lot of merchandise returned. She had eighteen months to gather her information, and she had complete cooperation from Petitioner (TR 196-199 App. A-44-A-47). Yet, she presented nothing to the Court to substantiate her finding except the bare statement that the regulations required her to make the change. The least she could have done would have been to analyze the information at hand and present, by a competent witness, a method of accounting that was capable of being observed and critiqued by the Court. The trial in the tax court revealed nothing about the qualifications of Rose Stuckey as an accountant or as having had accounting training. Her only qualification was that she had been a revenue agent for 7 years at the time of trial in 1979. That meant that when she started her audit in 1974, she had only 2 years experience, and when she finished the audit in 1976, she had only 4 years experience as a revenue agent. Compare this with the testimony of the attorney Mr. Wolbrink, (TR 85-86 App. A-23-A-24) with substantial tax experience, and that of Mr. Robley, a certified public accountant (TR 102-103 App. A-30-A-32) with 23 years experience. Why should any presumption in favor of the Commissioner prevail under those circumstances?

Mr. Robley testified that the so-called receivables that the Commissioner accrued (and which resulted in the deficiencies) would grossly distort income (TR 107-113 App. A-32-A-37). These "receivables" were only a list of customers which may have owed some money to Petitioner. Mr. Robley testified that they were not true accounts receivable (TR 107 App. A-32). We submit that the Commissioner did not sustain her burden of proof that her own method clearly reflected the income of Peti-

tioner. The burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the Petitioner. *Bradstreet Co. of Maine* v. *Commissioner,* 65 F.2d 943, 945.

(c) Permissive methods

We submit, first of all, by relying on the clear meaning of words, that this subsection is not applicable at all to any fact circumstances in this case. The subsection begins with the phrase, "subject to the provisions of subsections (a) and (b), a taxpayer may compute his taxable income under any of the following methods of accounting:". This subsection, then, is actually subordinate to subsections (a) and (b) which allow Petitioner to select its own method of accounting unless such method does not clearly reflect income. The Commissioner's position and argument, both in the tax court and the court of appeals, is that this subsection is paramount to (a) and (b), and that (a) and (b) are subordinate to this subsection. Under any interpretation of grammatical construction, the Commissioner's position is untenable. See *Blacks' Law Dictionary, Revised Fourth Edition,* 1968, in which "Subject To" is defined as:

> "Liable, subordinate, subservient, inferior, obedient to; governed or affected by;"

In construing tax statutes, the familiar rule prevails that the natural and ordinary meaning of the words used will be applied unless the Congress has definitely indicated an intention they should be otherwise construed. *Huntington* v. *Commissioner, supra.*

It is in this subsection (2) that the regulation states that in any case in which it is necessary to use an inventory, the accrual method must be used. However, this requirement is subordinate to subections (a) and (b). Therefore, if a cash or hybrid (combination of cash and accrual) method was regularly used by Petitioner and such method clearly reflected income, the re-

quirement of this subsection is not controlling because of the subordinate position such requirement must take to the allowances of (a) and (b).

We do know what prompted the Congress into making two similar provisions for acceptable accounting methods. It is clear that both (a) and (c) authorize the cash method or a hybrid of cash and accrual. We suggest to this Court that the permissive provisions of (c) are an outgrowth of the 1939 Regulation 39-41-2 entitled "Bases of computation and changes in accounting methods." We suggest that the Congress intended that the "permissive" methods in the 1939 Regulation related to a request for a change *by a taxpayer* to a different accounting method. In support of this theory, Reg. 39-41-1 entitled "Computation of net income." under the 1939 Code embodied the provisions of (a) and (b) of the 1954 Code regulations with which we are here concerned.

To summarize, Section 1-446-1-(a) and (b) allows Petitioner to select its own method of accounting within the statutory and regulatory limits of those subsections, and the Commissioner could not change the method of accounting from cash (hybrid) to accrual without first finding that Petitioner's method did not clearly reflect income. The Commissioner did not make such a finding; therefore, the decision of the Court of Appeals upholding the Tax Court in that regard is erroneous. Secondly, the provisions of Section 1-446-(c) have no application to the facts in this case, and the provision under subparagraph (2) of that subsection requiring an accrual method of accounting if inventories are used is subordinate to the allowed methods of subsection (a). These issues have not been settled by this Court and involves important questions of federal law that should be settled. In addition there appears to be a conflict between the First and Eighth Circuits on whether the use of inventories mandate a strict accrual method of accounting.

II

In The Alternative, Certiorari Should Be Granted For The Reason That The Eighth Circuit Court Of Appeals Has Decided A Question Of Federal Law Concerning A Deduction For Bad Debts That Conflicts With Opinions From The Second And Ninth Circuit Courts Of Appeals.

Petitioner had a major customer named Sound-On Tape Distributors, Inc. In 1974, Sound-On was indebted to Petitioner in excess of $176,000.00. Also, in February 1974, Sound-On was enjoined from selling certain "bootleg, duplicates, or counterfeit tapes." As a result, Sound-On's inventory was nearly worthless, and it returned the tapes to Petitioner. After crediting Sound-On for these returns, Sound-On owed Petitioner $176,574.22. (T.C. Opinion 4-5 - App. A-10-A-14). Sound-On had no monies to pay Petitioner after the middle of 1974. The only assets were racks and the inventory. The opinion of Mr. Holtzmann, of Sound-On, who ran the business, was that the business had failed and would not turn around. This was in the latter part of 1974. (Tr. 148-151 - App. A-39-A-42). Their purchases from Petitioner were charged to C.O.D. starting in 1974. (Tr. 48 - App. A-22). Mr. Robley, a C.P.A. for Petitioner, testified that the biggest part of Sound-On's obligation could not have been paid if the company liquidated. It was at least $107,000.00. (Tr. 134-135 App. A-37-A-38). The Commissioner's position is that the debt of Sound-On did not become worthless until 1978, at which time Sound-On ceased doing business and at which time Petitioner settled its account with Sound-On for $5,000.00

IRC Section 166, in part, covers the bad debt deductions we are concerned with in this part of our argument. Subsection (c) reads as follows:

> (c) Reserve for bad debts. In lieu of any deductions under subsection (a), there shall be allowed (in the discretion of

the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

It is obvious that a substantial financial setback occurred to Sound-On in 1974. The major part of their business was destroyed by the injunction against the sale of bootleg tapes. It is the position of the Commissioner that none of the debt of Sound-On was worthless or even to be considered under a reserve for bad debts as far as the 1974 return is concerned because the statutory notice contains no deduction for it and the Commissioner does not now concede that Petitioner is entitled to a deduction in this regard. If a taxpayer's evidence would satisfy a reasonable man that the debt can only be recovered in part, the Treasury may not disallow the deduction. *Clark* v. *Commissioner,* 85 F.2d 622. By ignoring the Sound-On bad debt issue, the Commissioner has acted arbitrarily and unfairly toward Petitioner on this issue and by so doing has erred by adopting a method that does not clearly reflect the income of Petitioner. The burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the Petitioner. *Bradstreet Co. of Maine* v. *Commissioner, supra.* It should be remembered that Petitioner was on the cash basis and that there was no need to consider the bad debt issue for tax purposes when the return was filed for 1974. Petitioner received the statutory notice of deficiency shortly after it was mailed on July 11, 1978 (par. 3 of Petition and admitted by par. 3 of Answer). This notice came almost three years subsequent to the time the return was filed in September of 1975. Had Petitioner known that it was going to be put on a method that would require an accrual of accounts receivable, it could have made the decisiion then to consider the bad debt issue regarding Sound-On.

So long as Petitioner reported its income on the cash receipts method, there was, of course, no need for an allowance for the bad debt of Sound-On since sales were reported only as pay-

ment for them was received. But under the accrual method some such allowance or reserve is standard accounting practice, and is, indeed, necessary to approximate as nearly as possible the actual income for the year's sales. Therefore, even though the taxpayer never made any estimate of the uncollectible accounts receivable on its books, it should be permitted to deduct a reasonable allowance for the bad debts stemming from its 1974 Sound-On debt balance. *Caldwell* v. *Commissioner,* (2d Cir. 1953), 202 F.2d 112, 116. The *Caldwell* case seems to be almost exactly in point on this issue. The Commissioner changed the taxpayer from cash to accrual. However, the Second Circuit required the Commissioner to allow a reasonable allowance for the bad debts stemming from taxpayer's credit sales.

The opinion of the Eighth Circuit on this point is in conflict with that of the Second Circuit. The Commissioner's action in not allowing any deduction for the bad debt of Sound-On is not only arbitrary but clearly erroneous when compared to standard accounting practice.

This Court has made a significant comment on this issue in *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522, 58 L. Ed. 2d 785, 99 S.Ct. 773. On page 549 of that opinion, and in commenting on the Black Motor formula for a reserve for bad debts, the Court stated:

> "If a taxpayer's most recent bad debt experience is unrepresentative for some reason, a formula using that experience as data cannot be expected to produce a "reasonable" addition for the current year. If the taxpayer suffers an extraordinary credit reversal (the bankruptcy of a major customer, for example) the "six year moving average formula" will fail. (citing, in footnote 32, *Calavo Inc.* v. *Commissioner,* 304 F. 2d 650, 651-52, 654 n 4, 655 (CA 9 1962). In such a case, where the taxpayer can point to conditions that will cause future debt collections to be less likely than in the past, the taxpayer is entitled to—and

> the Commissioner is prepared to allow—an addition larger than Black Motor would call for."

Both *Thor* and *Calavo* were already on the accrual method of accounting and had an established reserve for bad debts, as is standard accounting practice. In *Thor,* the Court held that the Commissioner did not abuse his discretion by stating that *Thor* did not show that the conditions at the end of 1965 would cause collection of accounts receivable to be less likely than in prior years. (p. 549). However, in *Calavo,* where the Duarte account had become insolvent, the Court reversed and remanded to the Tax Court with instructions that its judgment be vacated and that the cause upon the present record be resubmitted to the Commissioner for an exercise of his discretion free from his erroneous conception that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to reserve. (*Calavo,* at 655). In making this decision, the Court stated: (at 655)

> "The difficulty we face is that it is apparent that the Commissioner has, in disallowing any addition to reserve, refused to give any consideration whatsoever to the circumstances affecting the Duarte account. His discretion has thus been exercised under a misapprehension as to the considerations upon which it should be based. This, we feel, requires a reconsideration by the Commissioner of the question as to what under all of the circumstances would be a reasonable addition to reserve and a re-exercise of his discretion upon this question."

Here, again, the Eighth Circuit is in conflict with the Ninth Circuit as shown by the *Calavo* case. We suggest to this Court that a similar remedy be made available to Petitioner as was made in *Calavo.* In *Caldwell,* the Court made their own allowance without remand. In our case, however, Petitioner should be allowed to have a reasonable allowance in the Tax Court based upon the record itself or upon calculation by the

Commissioner of a reasonable allowance for a bad debt deduction for the Sound-On account.

Of course, if this Court decides in favor of Petitioner on Part I of our argument, it will not be necessary to decide this issue.

In summary, the decision of the Eighth Circuit Court of Appeals upholding the Tax Court in not allowing a deduction for the debt of Sound-On was arbitrary and clearly erroneous and in conflict with decisions of the Second and Ninth Circuits on similar questions.

WHEREFORE, Petitioner prays that a Writ of Certiorari issue from this Honorable Court to review the judgment of the Eighth Circuit Court of Appeals in *Record Wide, Inc.* v. *Commissioner of Internal Revenue*, No. 81-821 c(b). In the event that the Petition is granted, Petitioner prays that the decision of the Court of Appeals affirming the judgment of the Tax Court be reversed or, in the alternative, that such decisions be reversed and the cause remanded to the Tax Court for further proceedings to allow a reasonable deduction as a reserve for bad debts for the debt of Sound-On Distributors, Inc.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I do hereby certify that three true and correct copies of the foregoing brief in the above cause were mailed, postage prepaid, to: Mr. John F. Murray, Acting Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20520; and Mr. Jerome D. Sebastian, acting Chief Counsel, Internal Revenue Service, Washington, D.C. 20530; and The Honorable Rex E. Lee, Solicitor General of the United States, Washington, D.C. 20530; by placing same in envelopes so addressed and depositing same in U.S. First Class mail, on this 22 day of November, 1982.

CLAUDE HANKS